REPORT

OF THE STUDY GROUP

for

DEVISING ALTERNATIVES TO OCTROI

20 May 2006

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Introduction

The State Government, in Urban Development Department had constituted a study group to consider the issues relating to "Devising an alternative to the octroi levied by Municipal Corporations." The group held seven meetings. Details of the meetings and list of members of the group are given in **Annexure A** to the report. Municipal Commissioner, BMC has given his separate comments which may be seen at **Annexure B** to the report.

2.0 Abolition of Octroi

All the issues related to the levy of octroi were discussed extensively and in depth. It was generally agreed that octroi is a regressive tax which adversely affects integration of the economy, becomes a cost of business and interrupts the free flow of goods. It affects the poor the hardest. It, however, provides liquidity and a healthy cash flow. Any alternative to octroi therefore, needs to match the resources generated through octroi; it should be free from the defects of the current levy; should provide adequate liquidity to the urban local bodies (ULB's); and should avoid dependence on Government.

3.0 Need for resources

3.1 After the 73rd and 74th amendment of the Constitution, the responsibilities of the ULB's have increased manifold. It is necessary that the resources available to them should be commensurate with the responsibilities cast on them and that the ULB's have adequate autonomy in the matter of raising such resources.

3.2 Autonomy, however, does not mean that ULB's need to have autonomy in deciding the rates in respect of all tax resources allocated to them. ULBs in Maharashtra already have a discretion in the matter of fixing property taxes and user

charges. It was further noted that the world over property taxes are the mainstay of Municipal revenues. ULB's in Maharashtra should also be relying on property tax to garner additional revenue where the ULB's already have autonomy in fixing the rate of taxation. Rates of alternate taxation in lieu of octroi may in certain cases be outside the purview of the municipal bodies.

4.0 Ability to raise loans

As of today, the ULB's can avail of soft loans from financial institutions against the revenue flow from octroi. There was an apprehension that substituting octroi with a new levy (or new levies) may adversely affect the ability of the ULB's to raise finance to create and maintain improved infrastructure. The financial institutions may be wary of extending loans to them if the guaranteed flow of revenue is perceived to be vanishing. However, this would happen only if the alternative sources have no assured flows, or, are speculative in nature and are thus unable to provide comfort to the lender in escrowing such flows. The suggested revenues thus have to be such as to provide an assured cash flow to the municipal bodies.

5.0 Alternatives to octroi:

5.1 Government have already abolished octroi in Municipal Councils in the year 1999. The financial implications of abolishing octroi in the Municipal Corporations are however, much more substantial since their projected net revenue from octroi during 2005-06 was Rs. 4962 crores.

5.2 Since municipal finances depend heavily on octroi income, it will not be possible for them to discharge their responsibilities unless they are given an equally potent alternative revenue source or, are compensated in perpetuity from the State budget. The latter is not possible due to State's own developmental commitments and the heavy debt burden.

5.3 One merit in octroi tax is that its incidence falls largely on the residents of the very city. Any alternative to octroi should, therefore, ideally be such that its burden falls on the residents of that city alone.

5.4 Property tax is one such tax. This tax, however, is currently based on the rateable value of property and suffers from serious intra- city aberrations. It lacks buoyancy and has grossly underperformed since rateable values have not kept pace

with the market values. It is, theoretically, possible to abolish octroi completely, merely by levying property tax based on location specific "per sq. ft." tax rates and adjusting the unit rates in such a manner that additional yield from property tax reforms equals the loss of revenue in abolishing octroi. Total revenue from property tax in 2004-05 is, however only Rs. 1887 crore while octroi revenue in the same year is Rs. 4462 crore. Compensating octroi loss only through property tax reforms will, therefore, require steep increase in property taxes which though possible in long run, was considered infeasible in one go. It was however considered feasible to generate additional revenue through property tax reforms and increase in user charges for water & sanitation services to meet at least 50% of loss incurred towards abolition of octroi.

5.5 Another tax, whose incidence falls on the residents of that very city alone, is the profession tax. Its incidence falls only on those who are self -employed, or, are employed in that very city.

5.6 Another compensatory tax resource could be an additional VAT levy, whose proceeds would go to the Municipal Corporations. Such a levy would also be justifiable from the point of view that both octroi and VAT are taxes on commodities and abolishing/reducing octroi with corresponding additional VAT levy amounts only to a change in the mode of levy and collection of tax on commodities. It is theoretically possible to fix a local cess/surcharge/additional VAT levy in such a manner that the additional VAT yield equals the revenue loss incurred in abolishing octroi. As discussed elsewhere in this report, such a levy may have no adverse effect on the competitiveness of local trade and industry- both in intra and inter-state marketing vis-a-vis trade and industry in other states. Yet, human ingenuity being what it is, it may be undesirable to impose high additional VAT levy since large inter-state variation in VAT rates may ultimately result in trade distortions for as yet unforeseen reasons. It would be advisable to keep such levy to the minimum and search for other resources to compensate the revenue loss, as this levy, unlike octroi, will not fall entirely only on the local consumption and the surcharge will act as a constraint on the ability of the State Government to raise resources for its own purposes. An additional VAT rate of only 10 to 12% of the existing VAT rates was generally considered apposite, given the additional costs involved in inter-state trade.

5.7 The study group also considered if additional cess on electricity duty and on stamp duties could be levied for the purposes of raising resources for the ULB's. Both electricity and stamp duties are revenue sources of the State Government. The present electricity duty is inadequate even to meet the financial needs of the power sector. As regards, stamp duty, rates have already been reduced from 8 % to 5 % and an increase will be undesirable. Any sharing of revenue from these sources with ULB's will be no different than transferring amounts to Municipal Corporations from the State resources, as all monies are fungible.

5.8 The details of the present revenue from octroi, the per capita octroi income of the municipal corporations and the growth rates of octroi are given in **Annexure C** to the report. In case octroi is to be abolished, or is halved to begin with, the compensatory resource to the ULB's should, to the full extent, match the octroi revenue lost by each ULB.

5.9 To summarize, three different types of taxes can be considered while considering alternatives to octroi. They are Profession Tax (Direct tax), Property Tax (Tax on capital) and cess or VAT on goods (Tax on commodities).

6.0 Property tax as an alternative to octroi:

6.1 While the various alternatives were being discussed, at one stage a view was presented that reforms in the taxes being currently levied by the ULB's, notably property tax, should not be accounted as a substitute for octroi. The additional revenue arising from property tax is the own revenue of ULB's and should continue to remain so. The alternatives for octroi should be from amongst altogether new resources.

6.2 The fallacy of this view is only apparent. The substitute resources will have to be collected from the same set of local citizens. The cumulative revenue that is collected today from octroi and property tax may perhaps have to be collected under a single head. This may well lead to redistribution of tax burden to an extent. However, the quantum of burden will not change and the redistribution of tax burden will be only amongst the citizens of the same ULB's.

6.3 The Group deliberated if the reform of property taxes has the potential to yield additional revenue which equals or exceeds 50% of the octroi revenue. Some members of the group, who are Municipal Commissioners, are confident that property

taxes are grossly underrated and loss of octroi revenue, in fact, can be compensated in full through property tax reforms alone.

6.4 It was also noted that octroi as a tax in the BMC was introduced in 1965. Prior to that only 'town duty' was being levied on a very few items. At that time yield from property tax was the mainstay of municipal tax revenue for Mumbai. For example, in 1964, total revenue of BMC was Rs.23.64 Crore, out of which Rs. 18.59 Crore were from property tax while Rs. 1.54 Crore only were from 'town duty'. Property taxes accounted for 78.61% of total municipal revenue while town duty accounted for only 6.53%.

6.5 It would be instructive to examine the data from Mumbai regarding property tax with a view to guesstimating the likely rate at which property tax may have to be collected for the 50% abolition of octroi. In the year 2001-02, for which data is available in respect of all properties excluding special class of properties (e.g. storage tanks of oil and dairy companies, salt pan lands etc. and slum properties), the total area of built up properties was 12.06 crore square meters. Of this the area of residential properties was 8.2 crore square meters while the area of non-residential properties was 3.86 crore square meters. On the basis of the ready reckoner employed for stamp duty for 2001-02, corresponding capital values of these properties were Rs. 2,71,551 crore and Rs.2,19,845 crore respectively, aggregating to Rs.4,91,396 crore. It will be reasonable to assume a 20% increase in area since that year and a 20% appreciation in property values as per ready reckoner (the increase may be much more in actual terms in the market). The property values of all properties in Mumbai in 2005-06 can thus be safely estimated to be Rs.7,07,610 crore. The property tax demand, excluding water tax, state education cess and employment guarantee cess in 2005-06 was of Rs.1562 crore. The present tax factor [property tax as a proportion of property value] at present prices works out to a mere 0.22%. (The figure of Rs.1562 crore includes tax on special properties while the figure of capital values in 2001-02 does not include value of special properties. This would only reduce the incidence of present tax even further).

6.6 In developed countries, property tax is invariably higher than 1% of the property value. For example, in New York it is 1% Gen. Tax and 1.5% school tax, i.e. 2.5% of the value of the property. As against this, the property related taxes in

Mumbai are around 0.22% of property value as brought out in Para 6.5 above. The tax factor (property tax as a proportion to property value) is about 0.16% on residential properties and 0.30% on non-residential properties. Further, about 60% of the property tax collection is accounted for by the non-residential properties.

6.7 It is, therefore, possible to rationalize property taxes and even a reasonable improvement in property tax from 0.22 % to 0.44 % of property value, will yield Rs. 1500 crore in Mumbai. This will amount to 50% of the current octroi revenue. While revising the tax incidence, it would be possible to revise non-residential tax rates by a higher factor and increase residential property tax rates to a lesser extent. This could be easily possible as about 32% of the property area in Mumbai is other than residential. Further, while prescribing the average rate for residential properties it would be possible to keep the rate marginally higher than required and give rebates to chawls and old buildings for depreciation in value and shielding very old buildings from one time exorbitant increase in tax burden according to new formula by putting a cap on increase in tax.

6.8 In Pune too, according to the Municipal Commissioner, more than half the properties in the city pay property tax of less than Rs. 500 per annum. There are many cities, where ratable values are not revised for decades and there is immense potential to increase the revenue from property taxes. The calculations regarding the required increase from property tax reforms are shown in **Annexure D**.

6.9 There are a few Corporation areas where the property tax collection are extremely low and no reasonable increase in the rates of property tax will be able to yield the revenue required for abolition of 50% octroi. It is clear that these corporations will have to revise their user charges. While the potential for user charges is not significantly large in Mumbai and Pune, it is substantial in all other Corporation areas. It would therefore, be necessary to institutionalize the levy and recovery of sustainable user charges.

6.10 Since ready reckoners are issued every year, capital value of properties can be revised every two to three years to secure proper buoyancy in property tax collections.

6.11 A comprehensive reform of property taxes will certainly yield considerable revenue with strong potential for growth. The group felt that the additional revenue accruing from

reform of property tax should be one of the components of the compensation for octroi; especially if increase of property tax incidence accompanies the corresponding reduction / abolition in octroi.

7.0 Feasibility of levying profession tax by ULBs:

7.1 At present, the State Government is levying profession tax for funding the employment guarantee scheme. Indeed, prior to 1975, some of the ULB's in the State used to levy and collect profession tax for their own purposes. The authority of the ULB's to levy and collect profession tax was taken away at that time when the State Government decided to use profession tax as a resource for the employment guarantee scheme. The district wise figures of collection of profession tax by the State are enclosed as **Annexure E** to the report.

7.2 It needs, however, to be kept in mind that in addition to the profession tax being levied by the State Government, the ULB's are competent to separately levy profession tax on the same set of tax payers. The present constitutional limit of levy (Rs. 2500) applies to the authority levying profession tax and not to the tax incidence or tax burden on the tax payer (M/s. Kamta Prasad Aggarwal Vs. Executive Officer Ballabgarh AIR 1974 S.C.685). Thus, in addition to the profession tax being levied by the State Government, the profession tax can also be levied by the ULB's. The new levy will also be separately subject to the Constitutional ceiling of Rs. 2500.

7.3 The data about assesees under profession tax is already available with the Sales Tax department and is mostly in electronic form. Secondly, the ULB's are well placed, in fact better placed, to collect profession tax as they would be in proximate contact with the tax payers. Lastly profession tax administration in the State has suffered due to understaffing and short funding, since emphasis was always on higher yielding sales tax and as such its true potential has never been explored. The collections in municipal bodies from the same base and at the same rates are, therefore, likely to be significantly higher. Currently establishments not registered for sales tax tend to escape profession tax registration as well. The number of profession tax registration is, therefore, likely to increase substantially as it would be easier for municipal bodies to bring financial consultants, event managers and professionals under the tax net. Municipal corporations could also reduce the

base income for levy of profession tax and levy a small amount as profession tax in lieu of octroi. Income from profession tax could easily be as much as 150% of the existing collection by the Sales Tax Department.

7.4 Generally, a new levy needs a stabilization period before its full potential is realized. However, in case of profession tax, municipal collection would be at least as much as is being collected by the State Government. ULB's can obtain the names and addresses of entire tax payers database from the Sales tax department and use the same registration numbers merely by adding the letters 'LB' (for local body).

7.5 Implementation of profession tax would be further helped if the licensing provisions under the Shops and Establishment Act are given back to the ULB's for administration. The ULB's can even attempt to put in place a single license and single window clearance for all licenses issued by them.

7.6 If there is no legal infirmity, it would be ideal that only one agency collects both the profession tax levies in a given area. As stated earlier, Municipal bodies will be ideally suited to carry out this function. In the beginning, however, state levy may continue to be collected by the Sales Tax Department and be entrusted to municipal bodies after a year or two. Municipal bodies could however, be given an option to collect municipal profession tax themselves or to use the services of Sales Tax Department for the initial one or two years.

7.7 Levy of profession tax may not be restricted to Municipal Corporations only where octroi is proposed to be abolished. Even municipal councils should be authorised to levy this tax to augment their income.

7.8 It needs to be added that profession tax is a direct tax which a tax payer / employer pays personally. The burden of tax is, therefore, directly felt and is resented. However, its incidence will fall on the persons living within the local jurisdiction of the urban body, who were earlier buying goods subjected to octroi and now would pay a small amount as profession tax in lieu of octroi. Therefore the state government should not shy away from allowing ULB's this source of revenue in lieu of octroi.

8.0 Alternate VAT on commodities: different options:

8.1 The next option is to levy an account based Cess to be assessed and implemented by the ULB's. This has been implemented with partial success in the Navi Mumbai Corporation area. Unlike other cities, Navi Mumbai represents planned development. The industrial units and commercial establishments are generally well identified. This is not the case with historical cities which have grown over decades or centuries. This experiment did not succeed in Amaravati Corporation. Secondly, unlike octroi, the incidence of an account based Cess will fall only on those dealers who have a minimum turnover. Even a perfected Cess because of its essential nature is bound to create economic barriers to free trade by creating a preference for locally produced goods. Besides, the trade may well open warehouses just beyond the city limits. The Cess rates in different ULBs may have to be aligned with the respective existing octroi rates. This will also mean a multiplicity of rates in the State as the present octroi income as also octroi rates are different in each of the ULB's. The levy will certainly be prone to evasion.

8.2 An alternative to cess is introduction of VAT in lieu of octroi. The additional VAT can be levied either by the ULB's themselves or by the State Government.

8.3 Whether the additional VAT is administered by the ULB's or the State Government, there will always be certain constraints. The figures of the State sales tax collection are given in **Annexure F** to the report. In 2004-05 the pre-VAT revenue of the Bombay Sales Tax Act was of Rs. 11769 crore and that under Motor Spirit Sales Tax Act was Rs. 4950 crore, thus the two yielding a revenue of Rs.16719 crore. After introduction of VAT in 2005-06, the collection of VAT revenue (excluding revenue under the Motor Spirit Act) is about 3% less compared to the earlier year. This figure is deceptive. In the first year of VAT the return default has been unusually high. Apart from this, VAT dealers have claimed a one time input tax credit on their opening stock as on the 1st April 2005. It can be reasonably expected that the second year will see a growth rate of 25% in VAT revenue. Thus the estimated net collection in 06-07 from VAT and Motor Spirit Sales Tax will, therefore, be of Rs.14300 cr. and Rs. 7131 cr. respectively.

8.4 Out of the VAT (BST) revenue of Rs 14300 crores about 25% of the revenue accrues from 'declared goods' which cannot be taxed [including Additional VAT] at a rate exceeding

4%. The balance goods generate a revenue of Rs. 10,725 Crore at the existing VAT rates. An additional VAT of 10% of the existing VAT rates will yield an extra revenue of Rs.1075 crore. Apart from this, a tax @ 1% on motor spirits may yield about Rs.180 crore and 4% tax will accordingly yield Rs 720 crores in 2006-07.

8.5 Food grains could be taxed under the additional VAT although they are currently exempt under State VAT and were exempt under BST. This is especially so since in many of corporation areas food grains are currently liable to octroi. Some of the food grains including rice, pulses and wheat are "declared goods" and can be taxed at a maximum rate of 4%. As and when the State Government decides to tax food grains for State VAT, it will have to be ensured that the cumulative VAT rate does not exceed 4%.

8.6 Industrial units enjoying tax incentives under various package schemes would have to pay the additional VAT. Similarly those MIDC areas which are presently enjoying octroi exemption will have to forgo the benefit.

8.7 Sugar, textile and tobacco would for the time being remain outside the purview of the new VAT by whatever name it is called and can get included therein only after revision of the ADE Scheme. The CST rates are prescribed by the Government of India and cannot be increased and therefore CST revenue is of no consequence while evaluating the revenue potential of the additional VAT.

8.8 If the levy is administered by the ULB's then it is likely that the rates of VAT may well be different in different local areas in the same way as octroi rates differ in different local areas. This may create its own complications. Besides, an account based levy presupposes a certain level of competence and expertise in tax administration. The local authorities may be hard pressed to achieve these levels. A business with multiple locations will have to face multiple tax authorities. For want of common administration, different interpretations may well be adopted in different corporations. Further, under the State VAT regime, the tax payers can pay tax centrally at one place for all of their different places of business. But if VAT is to be administered by the ULB's, then the tax payers will have to pay VAT in each individual corporation area and will loose the convenience of paying taxes centrally.

8.9 Collection by the State will be administratively expedient. The State Government is already collecting VAT for its own purposes. It can very easily collect the additional VAT for the purposes of the ULB's. The additional VAT can also be supplemented by the levy of a general entry tax on goods entering the State from any place outside the State. The levy of entry tax can of course be best implemented with the help of check posts at the State borders. Check posts are to be set up by the State Government to serve different Acts and these can be used even for general entry tax.

8.10 Even if the State Government is to administer the tax, the scheme of collection and devolution will have to be kept outside the Budget. The devolution will have to be in real time. There should be no discretionary element in the quantum or periodicity of devolution. Where tax is levied for the purposes of local authorities and is allocated by the taxing authority to the funds of the local authorities, the tax receipts would not be the revenue received by the State Government and need not, therefore, go into the consolidated fund of the State. (Shanmugha Oil Company Vs. Market Committee AIR 1960 Madras 160 at 165).

8.11 A daily devolution to the ULB's out of the State enacted levy which is free from all control by the State Government is therefore possible. This can be done by depositing the tax receipts collected under additional VAT in a separate fund / bank account. This fund / bank account can be administered by an escrow arrangement between the State Government and the ULB's. The payments can be made say, within three days; the three days float sufficing as service charge for the bank. The quantum of devolution for each ULB should be decided only on the basis of per capita octroi income in the base year. The account should be operated by an Association of Persons (AOP) of municipal corporations. The AOP will be authorised to take all suitable decisions for operating the account.

8.12 Since Additional VAT will be vatable, there will be cases in respect of exports. etc., where additional VAT will be required to be refunded. Since additional VAT will be received in a separate bank account from where it will devolve to the municipal corporations with a lag of 2-3 days (i.e. float period), there may not be sufficient balance in the bank account on some days to honor the refund claims. This can be resolved by

availing overdraft facility from the bank concerned and /or maintaining a minimum balance in the account to take call of refund claims.

8.13 The study group noted that Additional VAT will fall with equal force even on inhabitants of the rural areas of the State who will not benefit from the proceeds of the Additional VAT. As to this, it must be kept in mind that the goods consumed in rural areas are even today almost always burdened with octroi paid in some urban area at an earlier stage. The same consideration holds good for the municipal areas currently not collecting octroi. Of course, goods which are manufactured locally in rural and semi urban areas and meant for local consumption are not subject to octroi. These goods are however, unlikely to be burdened with the new additional VAT since VAT is collected only after a dealer reaches a certain minimum turnover.

8.14 The VAT rate incidence may be different than the present octroi rates in respective ULB's since octroi rates differ at present in different ULBs while VAT rates will have to be uniform. Further, the per capita octroi income of ULB's shows a wide variation. The centrally collected Additional VAT will therefore have to be so distributed as to compensate the revenue loss to ULBs on abolition / reduction of octroi.

8.15 The study group concluded that the additional VAT levy should be administered by the State. The amounts collected should not form part of the consolidated fund and should devolve on municipal corporations on a daily basis through an escrow mechanism, described above.

8.16 As discussed earlier, declared goods would have to be excluded from the additional VAT levy, though such goods were subject to the octroi. These goods can be subjected to entry tax in the State, once border check-posts are in place. However, in respect of goods which do not get consumed in Maharashtra, the entry tax will have to be refunded, or, rebated against additional VAT.

9.0 Effect of Additional VAT on trade/ industry:

9.1 An important question which needs to be deliberated is whether the levy of Additional VAT will hamper the growth and detract from the competitiveness of the local trade and industry. After all, the introduction of Additional VAT will mean that the nominal rate of taxation on sales in the State will be

higher to an extent than the corresponding rates in the neighboring States. These days it is axiomatic that a high rate structure stifles trade and industry and affects their competitiveness. As against this, it needs to be kept in mind that VAT is in essence and in form a tax on final consumption. It never becomes a part of the cost of business. With the introduction of additional VAT, the aggregate VAT rate in Maharashtra will no doubt be slightly more than the comparable VAT rates in the neighboring states. But we shall do well to keep in mind that almost all items of daily use or consumption have to be sold locally at retail. This applies equally to goods manufactured in other, low-tax rate states. All goods sold at retail in Maharashtra, irrespective of the place of origin will finally be taxed at the self-same rates. Likewise, when goods are manufactured in Maharashtra but are sold inter-State or are exported, all the cumulative tax burden is rebated and the Maharashtra produced goods will, thus not suffer an unequal tax burden when these are sold locally or inter-State.

9.2 The only issue of concern will be direct sales from other states to consumers in Maharashtra. These goods will bear lesser tax burden than goods sold locally at retail. However these kinds of transactions are very low in volume or value. Further, if the levy of additional VAT is coupled with the levy of a general entry tax on goods imported from other States for direct consumption, then there is no reason why the levy of additional tax should affect the competitiveness of the local trade and industry even in this respect. As is mentioned earlier the Government is in the process of setting up border check posts which will enable the Government to implement the general entry tax.

10.0 Strategy for octroi abolition:

10.1 The group therefore, recommends that the existing system of octroi be done away with. There are then two options - to repeal the present system in one stroke, or to do so in two steps. The pros and cons of a phased abolition were seen to be as follows:-

Merits (1) The exercise of redeployment of staff will be easier.

(2) The efficiency of the new levy can be tested.

(3) It will be possible to have a re-look at the various options for alternate levies.

Demerits (1) In the initial period, for some time there could be double taxation [VAT + octroi]

(2) Octroi reforms will be on hold till the exercise is complete.

(3) Opposition from pro-octroi groups as well as groups seeking octroi abolition may continue for a longer period.

10.2 Abolishing octroi in one stroke may require a high rate of additional VAT equal to 40% of the existing rates which would be undesirable and will also leave the property tax system unreformed.

10.3 After considering different issues involved, the group recommends that octroi be abolished in two phases.

- In the first phase the date for the levy of Municipal Professional Tax as well as the levy and collection of Additional VAT by the State Government on behalf of the ULB's shall be notified and the octroi rates shall be halved from a date three months hence.
- The balance 50 % of octroi levy shall be abolished within a predetermined date 12 to 18 months thereafter. The interim shall be used by ULB's to restructure the property taxes in such a manner that increased property tax yield fully compensates the balance 50% loss of octroi revenue. The municipal corporations shall also improve their user charges in this period.

10.4 The Additional VAT levy shall be administered by the State but the amounts collected will not form part of the consolidated fund of the state. These shall be credited in a separate bank account in the name of an Association of Persons of ULB's and the monies shall devolve on municipal corporations on a daily basis through an escrow mechanism in the proportion described in **Annexure G** (Column 8).

10.5 Even though the amounts of Additional VAT could devolve on daily basis, yet the flow of funds throughout the month will not be uniform, as is the case with octroi. Since VAT is paid by the dealers on a monthly basis, payments tend to be higher in the last week of the month and significantly lesser on other days. Similar cash flow problems would be applicable to Municipal Profession Tax. To safeguard the liquidity problems of the municipal corporations, it would, therefore, be necessary to have an overlap period of 3 months where the municipal

corporations would be allowed to collect octroi at full rates even after the imposition of Additional VAT / Municipal Profession Tax. This period of three months would in addition to stabilizing the cash flow help to find acceptance by the stakeholders for the new levies and would thus help provide a level of comfort for the municipal corporations.

10.6 Imposition of profession tax by the ULB's would require enactment of a separate Profession Tax Act. The job of registration under the Shop and Establishments Act should also be given back to the municipal bodies. Property tax reforms would require amendments of the respective municipal laws. The levy of additional VAT would require either amendment of the existing VAT Act or enactment of a separate Law. All of the legislative changes must be in place before the octroi rates are reduced. The proposed levy of general entry tax would require a separate legislation and also prior assent of the Government of India. The present proposal can however, be implemented even without introduction of general entry tax act

10.7 After all legislative changes are in place, a date should be notified to bring into effect the profession tax and additional VAT levies; octroi rates should be halved from a date 3 months hence and its outright abolition should be notified simultaneously from a date 12 to 18 months away from the date of octroi reduction to half.

10.8 It is not necessary that the alternative levies come into effect on the 1st of April. The new levies can be brought into effect at any time after the administrative and legal issues are sorted out.

10.9 It is now possible to quantify the rates of the different taxation proposals discussed so far. **Annexure-G** enclosed with this report sums up the position where the octroi rates are reduced by 50% and the loss in revenue is compensated as follows:

- The first component of compensation is Municipal Profession Tax. The profession tax projections for each corporation area are made on the basis of population and by estimating the fraction of population liable to pay the tax. The rates are assumed to be the same as presently levied by the state government.
- The balance needs to be compensated by the additional VAT levied for this express purpose. The additional VAT will be levied both on motor spirits and on other goods. At

present the octroi rates on motor spirits are in excess of 4%. This 4% octroi on Motor Spirits is equivalent to an additional VAT of over 5%. If an additional VAT on motor spirits is levied @ 4% it is expected to yield a revenue of Rs. 720 crore in the year 2006-07. The balance revenue loss will be compensated through levy of Additional VAT on other commodities. A levy of Additional VAT @ 10% of the current VAT rates will yield a revenue of Rs. 1075 crore in the year 2006-07. This rate will suffice to bridge the gap in revenue loss. (It would however, be necessary to look at these figures again after the final figures of receipts for the year 2005-06 are available).

10.10 Revenues from Additional VAT collection will accrue to the municipal corporations. Since Additional VAT rate is determined with a view to compensate loss due to reduction in octroi rates to half, it should not be open to government to unilaterally reduce the rate of Additional VAT at any later date.

10.11 Simultaneously and along with the Phase one reforms, the municipal corporations should also be enabled and required to levy property tax according to location, based on property values or, "per sq. ft. tax" rates. Twelve to eighteen months time may be given to the corporations for carrying out the property tax reforms and adjusting the property tax rates in such a manner that additional yield from the property tax reform compensates them for the likely loss in abolishing remaining 50% octroi after this period.

10.12 Along with the reforms in the property taxes, the municipal corporations would be required to reform the user charges for water and sanitation. There is a very large gap between the costs incurred and the user charges received. This gap needs to be removed entirely. While the potential for user charges is not significantly large in Mumbai and Pune, it is substantially so in other corporation areas. The municipal finances will turn healthy only on reforms of user charges.

10.13 However, if there is any shortfall in revenue even after increasing the property taxes by 200% and revision in user charges, the State may increase stamp duty rates in the corporation area to the extent necessary but limited to 2% to meet /narrow the gap. This device should apply if it becomes necessary to increase the property tax burden by 200% or more. In other words the increase in property taxes should have a cap of 200%.

10.14 Because of the rapid urbanisation of the State and in view of the Government policy, new corporations will continue to be established in the State. It will of course remain open to these Corporations to levy and collect profession tax from their own citizens. But equally, these corporations will not be partaking from the collection of additional VAT. The rate of additional VAT is to be fixed with reference to the needs of the existing corporations and that rate cannot be increased every time a new corporation is created.

10.15 Stamp duty on immovable property is currently collected @ 5% which has given a revenue of Rs.3600 crore in 2005-06. A 2% rate would mean an additional revenue of Rs. 1440 crore in 2005-06 and Rs.1590 crore in 2006-07. In lieu of the additional VAT, the newly established corporations should be compensated by increasing by 2% the rate of stamp duty applicable to real estate [and related] transactions taking place in their jurisdiction. Any remaining shortfall should be made good by suitable adjustments in user charges.

10.16 In future the percentage devolution for each of the ULB should be reviewed by the State Finance Commission or, once in five years by another suitable body. The recommendations of the commission should normally be binding on the Government.

11.0 Summary of Recommendations:

11.1 The group recommends that the present system of levy and collection of octroi should be abolished.

11.2 The loss due to full abolition of octroi in the year 2006-07 is of Rs. 5572 crore. It is possible to compensate the ULBs fully for loss due to abolition of octroi.

11.3 Abolition of octroi will require imposition of Municipal Profession Tax by ULB's; imposition of Additional VAT; reform of property taxes, coupled with revision in user charges. Imposition of a general entry tax can be considered at a later date.

11.4 It is true that octroi collections have a high buoyancy which is matched by Additional VAT [both being commodity taxes]. In the long run Municipal Profession Tax may lack such buoyancy. However, in the initial years profession tax receipts would certainly grow at a higher rate than receipts from VAT or property tax. Besides the buoyancy in property tax collection

should suffice to compensate the lower buoyancy of profession tax.

11.5 The municipal bodies shall be permitted to impose and collect their own independent professional tax. Imposition of profession tax by the ULB's would require enactment of a separate Profession Tax Act. Municipal bodies would have an option to collect municipal profession tax themselves or to use the services of Sales Tax Department for the initial one or two years.

11.6 The job of registration under the Shop and Establishments Act should also be given back to the ULB's to facilitate imposition of professional tax by municipal corporations / councils.

11.7 The State Government shall on behalf of the municipal bodies levy an Additional VAT at the rate of 4% on motor spirits and at the rate of 10% of the current VAT rates on other commodities (of course excluding "declared goods"). This Additional VAT levy will have to be fully VAT-able. These Additional VAT receipts will not form part of the Consolidated Fund of the State. The collection shall be kept in a separate account. The amount would devolve directly on the ULBs on daily basis (as provided in Column 8 of **Annexure G**) so as to provide adequate liquidity to the ULBs. The levy of additional VAT would require either an amendment of the existing VAT Act or enactment of a separate Law. Since additional VAT rate has been worked out as a compensation for elimination of octroi, Government would have to commit not to reduce these rate unilaterally at a later date.

11.8 The capital value based levy of property tax should also be made compulsory by statute and be enabled by suitable amendments of the respective municipal laws.

11.9 The revision in user charges must be mandated by statute. The law should provide for 15 to 20% annual increase till full cost recovery is achieved. Any subsequent increase in cost should be met by revising the user charges under statutory compulsion.

11.10 The proposed levy of general entry tax would require a separate legislation and also prior assent of the Government of India. The present proposal can however, be implemented even without introduction of general entry tax act.

11.11 Octroi should be eliminated in two phases. After all legislative changes are in place, a date should be notified to

bring into effect the profession tax and Additional VAT levies. Octroi rates should be halved from a date 3 months hence. The Government should simultaneously notify a date for the full and final abolition of Octroi which should be a date 12 to 18 months away from the date of octroi reduction to half.

11.12 The State Government should give guarantee on a tapering basis for three years starting from the first reduction in octroi rates, for the loss, if any, incurred by the ULB's in case the additional VAT does not yield the anticipated revenue.

11.13 Within these twelve to eighteen months municipal corporations should complete restructuring of the property tax according to a capital value/area based system. Simultaneously, they should revise the user charges for water and sanitation services to ensure full cost recovery.

11.14 In a few corporation areas, where the existing property tax collections are extremely low, the upward revision of rates would have a cap of 200%. If the revised property tax and revised user charges do not yield adequate revenues, then stamp duty rates for real estate and related transactions applicable to that jurisdiction should be revised to the extent necessary, but limited to 2% to meet/narrow the gap.

11.15 In future, the percentage devolution for each of the existing ULB should be reviewed by the Finance Commission or, once in five years by another suitable body. The recommendations should normally be binding on the Government.

11.16 Corporations established after the implementation of the current reforms should get the requisite amounts by introduction of an additional stamp duty @ 2% applicable to real estate [and related] transactions in their jurisdiction. Any remaining shortfall should be made good by revising the user charges.

11.17 This report should be made open for public debate in order to promote participation by all the stakeholders.